

**POLICE & FIRE PENSION INVESTMENT BOARD  
AUGUST 10, 2006**

Members present: Mark Meyerson, Police Department (Chairman)  
Don Taute, City Personnel Director (Vice-Chairman)  
Greg Sorensen, Police Department  
Brad Thavenet, Fire Department  
Mark Westphalen, Mayoral Appointment  
Gerry Finnegan, Mayoral Appointment  
Michael Donnelly, Mayoral Appointment

Member absent: Don Herz, City Finance Director

Others present: Russell Fosler, Police Department  
Jeremy Gegg, Fire Department

Personnel Dept.  
Resource Staff: John E. Cripe, Compensation Manager  
Paul Lutomski, Pension Officer

Consultants: Max Callan and Todd Peterson of Smith Hayes Advisors

09:04 a.m. Investment Board Chairman Mark Meyerson calls the meeting to order and all present introduce themselves. Mark Meyerson states he did not seek re-election to the Board will be replaced by Police Officer Russell Fosler on September 1, 2006 to represent the Police Department. Fire Captain Randall Case did not seek re-election to the Board. Fire Apparatus Operator Jeremy Gegg was elected to represent the Fire Department. Mr. Meyerson asks Max Callan to present their recommendations for asset allocation.

Max Callen: Max distributes handouts of his Powerpoint presentation. (handout available in pdf format: "20060810 SH presentation") Market and Economy Review. US and Int'l equities best performing asset classes shown from 1995-2005. Fed has been increasing interest rates. Purpose of rising rates is to slow economy and curtail inflation. US economic growth is slowing but oil prices and interest rates are increasing. The bond yield curve is very flat. A traditional yield curve is for increasing rates with increasing durations. An inverted yield curve is the opposite. Bonds did not return well last year. In 1978 12% of US bonds were owned by foreign entities. It is now 52%. The Fed has therefore lost a little of their power to control interest rates. Japan is the largest holder. The US is not as dependant on OPEC oil as it was 30 years ago. China is a big consumer of oil and price competition with them could increase oil prices. In 1999 67% of S&P 500 company's pensions were overfunded, today 13% are overfunded.

US Economic growth is not mirrored in stock market returns. The markets can be over or undervalued. BRIC is Brazil, India Russia, China. They are growing much faster than the US. North American is 8% of the world's population. Trends are that the massive population bases outside the US are growing faster than the US. Very cheap labor force. Cheaper to buy a log in the US, ship it to China, have it milled and ship it back, than have it milled in the US.

7.5% is the actuarial rate of return and the Board's target rate. In allocating assets we are trying to achieve that return with the least amount of risk and highest probability of success. Over 1986 – 2006 without constraints the model would have had two assets, mid-cap value 81% and Lehman brothers aggregate 18%. Time periods make a big difference. In 2006 it would use EAFE, and Bonds.

When we started this process in 2003 we assumed equity markets would be like the 1960-70 meaning fairly flat, value would out perform growth, small outperform large cap, bonds would have low returns like the 1950s.

2005 return hypothesis. Interest rates will remain low but rising, mid and small outperform large. Value and growth perform similar. Int'l outperform US equity.

Slide showing min., max., target, and actual allocations. Underweight in mid-cap growth and global equity because overweight in real estate, but that did not hurt returns because real estate performed well.

Slides of 2005-06 assumptions and actual performance.

Mark Meyerson: What percent is normally invested in real estate?

Max Callen: It depends on your outlook for returns and risk with that class. If we would have input the 18% if earned the model would have recommended more real estate.

Slide comparing asset returns to index returns. Underperformed on Foreign at 24.1% vs. 24.8%. Over on large growth at 15.9% vs. 5.4%. Each class' return discussed.

Theme for 2006 discussed as oil and energy higher, flat interest rates and slowing economy, Unrest in Iraq, Iran, North Korea, Israel, residential real estate slowdown, and mid-term elections 8.1% average for S&P500 with 8 down years. Each discussed. Forces impacting market are baby boomers, declining dollar, and globalization of markets. Each discussed.

Slide of Long term issues. Under funded pension plans. Cost of government entitlement programs. Population demographics issues involving baby boomers and immigration. Baby boomers are 76 million people and 26% of population. A lot of wealth in housing. Most of population not ready for retirement. They do not have DB pension plans.

They will end up working a lot longer than they think. Each discussed.

Market Demographics. Foreign will outperform US. Value will outperform growth. Correlations of asset classes discussed. A correlation of 1 means movement together. US equity market asset classes are becoming more correlated to each other. Average return of Russell 1000 value and growth and EAFE under and over performance relative to annual index returns are discussed.

Historical standard deviations for asset classes 1986- 2006 displayed and discussed.

2006-07 model recommendations: Overweight value, mid and small cap, maximum allowable allocation to foreign/global, reduce real estate. Hypothetical returns shown.

Slide with those inputs brings hedge funds down to 3% and real estate down to 2%. You may not want to do that with the return you have been getting. A second forced allocation puts real estate at 10% and hedge funds at 7%. That reduces large cap value from 15% to 3%.

Paul Lutomski: We have 12.8% in real estate now. We would have to sell \$4.5 million to get down to 10%.

John Cripe: We could enter a sale order for CNL to do that.

Paul Lutomski: So what we have is two different allocations and the committee needs to pick one or do something completely different.

Max Callen: Yes. In the future I would like to see you consider increasing your policy stated foreign from 20% to 30%, global from 10% to 20%.

Gerry Finnegan: Global is just US and foreign. Why are we treating that as a separate asset class.

Paul Lutomski: The committee voted to include global as an asset strategy.

Max Callen: Since we don't meet that often the manager can switch between US and foreign if we use global.

Gerry Finnegan: So that is not an allocation decision. It is betting the manager can time the move.

Max Callen: Yes, we are betting the manager can time the move better than this committee. Even US large growth managers have a range of foreign they can use.

Gerry Finnegan: That gets to the issue of style drift. The manager isn't doing what we hired them to do.

Max Callen: If you hire a global manager to position you, they move assets as they

see fit around the world. They are doing what you hired them to do.

Gerry Finnegan: Again, this is not an allocation decision.

John Cripe: You have two issues. One is to decide an asset allocation. Second you have been asked to consider changing the policy in your next meeting to increase foreign and global. Today you have two allocations and need to pick one.

Gerry Finnegan: I understand, but this body needs to decide if they want to actively or passively allocate to foreign and US. IF it is done actively we know with certainty what is allocated, if we do it passively and hire a manager that is going to try to outfox the market the value of our allocation decision is diminished.

Max Callen: That get back to the whole discussion of index or active managers.

Gerry Finnegan: I don't know that we actually voted on that.

John Cripe: Every time you vote on the allocation and in January the specific securities, you vote to reject or retain or add specific managers. None of those are indexes.

Gerry Finnegan: We have an expert here that is saying that unlike most managers this manager is going to match or exceed his index. We know we can match the index if we do it passively. On average the index will always beat active managers over time. If our global manager has wide latitude it undermines our allocation process.

Max Callen: It does if you say you don't want to vary from your target allocations. If you say as a group that you do not mind some limited movement within the allocations then it does not undermine your process, it executes your process. You compare results to a global index.

Gerry Finnegan: Investment timing is a mine field. The decision is do we want specific allocations to foreign and US or some movement because we use global manager.

Max Callen: The decision was made a year ago that you did want a global manager so we put one in the mix. On the table now are two allocation models. One retains your existing real estate and hedge fund allocations, and we are very comfortable with that, or do you want to reduce them and add large cap value.

Mark Meyerson: We need to decide between these two models today.

Paul D. Lutomski: To decide you could compare expected risk and return. The forced model one year projection shows 8.4% vs. 8.6% return, and 9.0% vs. 9.8% risk. Best case numbers are 27.1% vs. 29.1%. Worst case returns are -8.2% and -9.4%. Probability of negative return is 52.4% vs. 52.7%. The forced has less return and less risk. Is the increased return of the

non-forced worth the added risk? These are ways to take allocations and translate them to risk and return.

- John Cripe: There is nothing wrong with either. The practicality is that we will not get to 2% real estate until at least a year from now.
- Paul Lutomski: The way we operate now is odd. We have a 12.8% real estate allocation, but the target is 2%, with a notation that if we think we have a reasonable expectation to earn 7.5% we can go above the 2% allocation. Under that scenario, that is why we started selling CNL Hospitality REIT.
- Mike Donnelly: We hired Smith Hayes to be our investment advisor. We need to seriously consider their recommendations. You are not advising on real estate and hedge funds.
- Paul D. Lutomski: I got a report yesterday from JP Morgan dated 7/25/06. For the next 12 months they expect a 9-12% return, 3 years is 8-10%. When Max plugged in 10.5% it pushed real estate up to the policy maximum allowable of 15% rather than 2%. The forced 10% allocation is to meet a mid ground.
- Max Callen: I don't have a problem with the forced model.
- Don Taute: Last year real estate returned 18%, and this year it is expected to earn less. We heard that last year also. There is some stability from the cash flow and in-place leasing.
- Paul Lutomski: Cash flow is nice, but we are seeking a total return. If we need to sell something to make our cash flow we will do that.
- Gerry Finnegan: We have an infinite time horizon. How different would this be for a twenty year time horizon.
- Max Callen: Probably not too different. Real estate has a low standard deviation.
- Mark Mayerson: Any motions?
- Don Taute: "I move that for purposes of the asset allocation model, that we adopt the one that proposes a portfolio return of 8.4%"
- Gerry Finnegan: "I second the motion"
- Mark Meyerson: All in favor say Aye. (all Ayes) Motion passes. Thank you Max. Any new business?
- Don Taute: At our last meeting we discussed Fiduciary Liability coverage. Rough quotes for \$1 million coverage is \$9,500 to \$12,000, \$2 million is \$13,500 to \$17,000 through St. Paul Travelers. I think it make sense to do it. This also includes the civilian pension. I'm not sure how to allocate the payment at this time. The exposure on the civilian plan is less.

Gerry Finnegan: We are covered if act in good faith. What would we be getting?

Don Taute: Attorneys that are familiar with this type of litigation and coverage for issues wherein we feel we are acting in good faith and the other party does not think so.

Mark Meyerson: At the conferences I have been to fiduciary liability insurance is always mentioned as good idea.

Don Taute: I will pursue this further.

Mark Meyerson: Meeting adjourned.